

## The Macroeconomic Model: Short Run to Long Run

In this activity we are working from the short run to the long run. The aggregate demand curve is downward sloping and the aggregate supply curve is upward sloping. The aggregate supply curve is upward sloping in the short run because of slow wage and price adjustments within the economy.

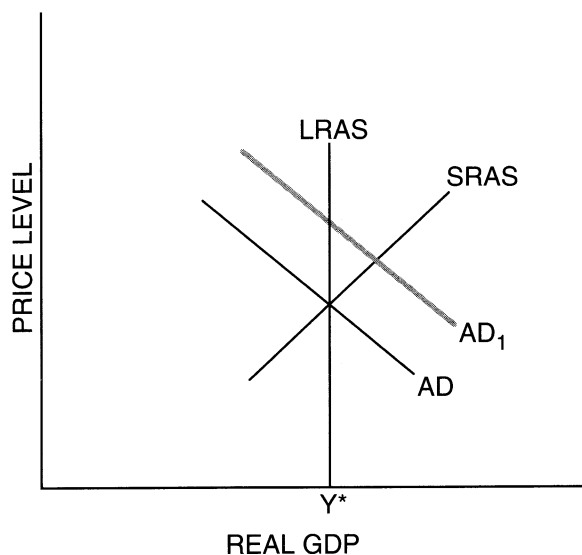
### Part A

1. In the following graph, suppose the aggregate demand shifts from AD to AD<sub>1</sub>. How will the economy react over time? Assume that no monetary or fiscal policy is undertaken.



Figure 28.1

### Increase in Aggregate Demand Starting at Full Employment



- (A) What will happen to output in the short run? Explain.
- (B) What will happen to output as the economy moves to the long-run equilibrium? Explain.
- (C) What will happen to the price level? Explain.

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(D) What will happen to wages? Explain.

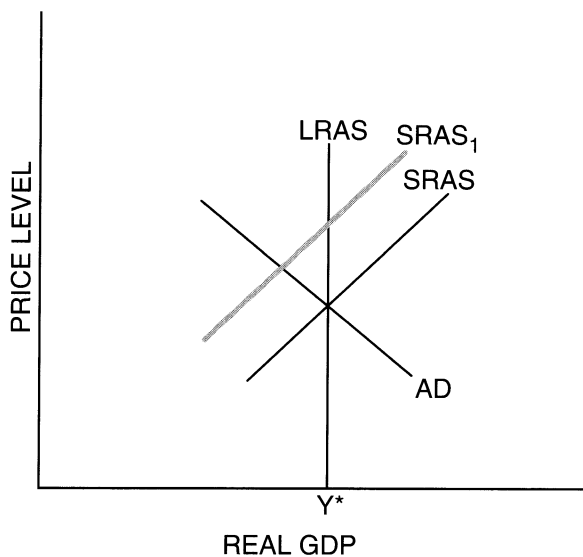
(E) In the graph, draw the shifts in AD and SRAS that you think will occur. Indicate the final aggregate demand and short-run aggregate supply curves by labeling them as  $AD_f$  and  $SRAS_f$ .

2. In the following graph, suppose the aggregate supply shifts from SRAS to  $SRAS_1$ . How will the economy react over time? Assume that no monetary or fiscal policy is undertaken.



Figure 28.2

**Change in Short-Run Aggregate Supply**



(A) What will happen to output in the short run? Explain.

(B) What will happen to output as the economy moves to the long-run equilibrium? Explain.

(C) What will happen to the price level? Explain.

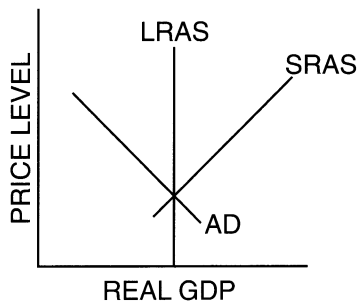
(D) What will happen to wages? Explain.

(E) In the graph, draw the shifts in AD and SRAS that you think will occur. Indicate the final aggregate demand and short-run aggregate supply curves by labeling them as  $AD_f$  and  $SRAS_f$ .

**Part B**

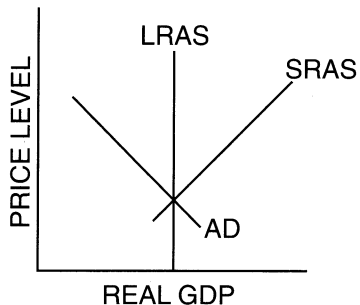
Read the description of each exogenous shock to aggregate supply and aggregate demand. Draw a new SRAS or AD curve that represents the change caused by the shock in the short run. Explain the reasons for the change in the graph, and then explain what happens in the long run if no stabilization policy is implemented. Identify the final AD curve as  $AD_f$  and the final SRAS curve as  $SRAS_f$ . If there is a change in LRAS, show the change and label the new curve  $LRAS_f$ .

3. The government increases defense spending by 10 percent a year over a five-year period.



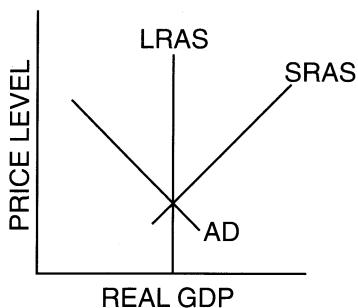
EXPLANATION:

4. OPEC cuts oil production by 30 percent, and the world price of oil rises by 40 percent.



EXPLANATION:

5. The government increases spending on education, health care, housing and basic services for low-income people. No increase in taxes accompanies the program.



EXPLANATION:

6. Can the government maintain output above the natural level of output with aggregate demand policy? If the government attempts to, what will be the result?

